

Beyond Planning and Mercantilism: An Evaluation of Pakistan's Growth Strategy

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"The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back".

John Maynard Keynes (1883-1946) *The General Theory of Employment, Interest and Money*, ch. 24 (1936)

INTRODUCTION

Through the nineties Pakistan remained preoccupied with crisis management. All debate and policy was, as a result, involved with current policy and our coping with the IMF programmes. Adjustment was the main theme leaving little room for growth initiatives.¹ A lively debate has raged on the distributional impacts of adjustment policy on which the government and the thinking community have adopted opposing stances, often with much emotion. With this focus of economic and political discussion on critiquing of the current government and its policies, there has been little effort put in understanding and reviewing the country's growth strategy. This paper attempts to assess the evolution of Pakistan's long-term growth strategy.²

It is my contention that the growth strategy remains inertia-ridden because of the lack of an academic community and debate.³ The paper will also attempt to

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¹See Hasan (1998).

²Haque and Sheikh (1994) and Samad (1993) have argued that the economics profession and research are both severely underdeveloped. Debate on critical issues, such as long-term growth strategy, is very thin.

³This is the reason for putting Keynes's famous statement on economists at the beginning of the paper.

identify the actors who influence and shape this strategy. This will be followed by what changes should be made in that strategy, based on more recent developments in economic thinking and experience in the world. For long-run sustained growth that will lead us to join the club of the more advanced countries, a new strategy based on the latest research findings will be needed. Finally, I shall point to the factors that impede the adoption of such a strategy, and especially to our owning such a strategy.

1. POST-INDEPENDENCE PARADIGM OF DEVELOPMENT

When Pakistan attained independence, most of the developing world was either a colony or behind the iron curtain. In this immediate post-war era, Keynesian policies of activist government were in force and Lord Keynes's brainchildren, the new Bretonwoods institutions, were beginning their mission of managing the world economy and eradicating poverty. Economists of that time turned very confidently to develop the poor countries. Pakistan, which lacked any real economic profession, quickly accepted most of the new development prescriptions. At that time, expectations were high from this country.

Haque and Khan (1998) have noted that the expatriate economist filled the policy vacuum created by the lack of indigenous economists in Pakistan's early days. The Harvard advisory group, which set the country's economic policies at that time, based them on the economic thinking of the time. Development economics of the time basically rested on five propositions:⁴

First, was a desire for a "big push for development" based on the widespread levels of poverty, which at that time appeared to be fuelling the global demand for communism.

Second, this was an era of Keynes when markets were mistrusted and governments had discovered new tools of planning and activist monetary policies.

Third, early development economics strongly believed in dualism where there was a traditional, non-market sector and a modern global sector. The latter was obviously more productive than the former and an important task for policy and government intervention was to move people out of the traditional sector into the modern. Hence, development poverty levels, economic development must be given priority over all other activities.⁵

⁴See Lal (1997) and Ranis (2004) for a survey of development thinking of that time.

⁵Basically, the poor agrarian economic base of developing countries was considered to be irrational, unable to develop markets and respond to price incentives. Consequently, the economy and economic actors were unable to self-organise, which is a fundamental principle of Smithian and neoclassical economics. Once again, a large role of government was envisaged.

Fourth, developing countries were labour-abundant and capital-poor. In addition, they would not be able to save enough for their capital requirements. Hence for their governments it was necessary to conserve their capital through capital controls and seek capital from overseas.⁶ But since the modern sector was very small and even the government had no international credit-worthiness, IFI-lending with its conditionality was the main vehicle for capital accumulation. The development economist was therefore to develop new theories for developing modern, productive sectors. These would be financed by the IFI and the government would implement policy in a highly regulated closed economy. This was the birth of the government-led planning models.⁷

Fifth, in keeping with the dualistic conceptualisation, emphasis was placed on industrial production.⁸ Agricultural productivity increases were to finance a move to modernisation and industry. Industrialisation was considered an important indicator of progress.⁹

These assumptions led to a model of economic development that would be based on three important actors that would determine the future of Pakistan—the government, the external donor, and the external expert.¹⁰ The last would supply policy thinking, the second the required funding, and the first would be an implementing agency.¹¹ Given the view of backwardness, existing markets and economic relationships were looked on with suspicion.¹²

The model also had explicit mercantilist overtones inherent in the planning approaches adopted (see box). Policy sought to boost production and exports through controls on the domestic market. Controls included curbs on domestic consumption, resource utilisation and allocation and market development. Under growing IFI pressure these controls have been relaxed but the growth strategy continues to rely on the spirit of mercantilism.

⁶Recall the choice of techniques literature where even the capital-labour ratio was treated as a policy variable.

⁷Harrod-Domar growth model, where growth was a simple process of capital accumulation based on a simple relationship between production and capital, was mainly used in these new planning models.

⁸This is not surprising since manufacturing activity was at its zenith in this period of global history.

⁹The early planning model focused entirely on industrial development through protection and subsidies. The terms of trade were fixed towards industrial production by the policy-maker. Within industry, policy tried to foster export through subsidy regimes and protect import-substitution industry. Import for consumption was always discouraged. Essentially, this approach mounts to the eighteenth-century 'mercantilism'.

¹⁰This was not peculiar to Pakistan. Almost all developing countries followed this model.

¹¹Recall these were also the days of socialist and Marxist thinking, where the market was held under suspicion. It is not surprising then that markets and openness played little role in those days.

¹²Later research did vindicate the economic rationality of the traditional sectors many years later. Schultz (1964) and McCloskey (1991) showed that the peasant was rational even in land fragmentation; and Akerlof (1970) showed that the money-lender was not the monopolist that he was normally assumed to be. The traditional sectors did indeed respond to market incentives.

Box 1**Mercantilism**

Mercantilism is a form of economic nationalism, the main objective of which is to build a wealthy and powerful state. In this system, policy attempts to generate external surpluses through controlling the flow of imports while actively promoting exports.

Mercantilism played a dominant role in the economic thought of Europe covering the period from the 16th century to the late 18th century. The objective was to bring gold and silver into a country through maximising export and minimising imports. In the early nation state, merchants and traders influenced governments to a policy of protection of domestic industry and trade often at the expense of consumers.

Typically mercantilist policies have sought to provide capital to establish new industries, grant tax exemptions to these industries, establish monopolies over local and colonial markets (e.g. The East India Company), impose tariffs and quotas on imports, prohibit the import of goods produced domestically etc. On the export side, governments have banned the export of tools and capital equipments as well as the emigration of skilled labour. In short, the domestic economy was protected from foreign competition.

The most important mercantilist policy-maker in France was Jean-Baptiste Colbert who used protectionist policies to encourage exports while limiting imports at the cost of the consumer. In England, mercantilism was supported by Robert Walpole. Tariffs on imports were imposed to control trade, English goods could only be carried in English ships etc.—colonies could only trade with their mother country which was another restriction.

(a) Growth of Government and Decline of Governance

To understand the political economy of Pakistan, it is important to understand and analyse the impact of this early development thinking. The combination of the external donor and government and a deep suspicion of the market led to the development of the planning model that formed the basis of our economic policy for many decades.

In this new planning model, the government took on more and more of the market and social functions in the economy. The British war economy had already put in a large number of controls in place. These included capital and current account controls, financial repression, constraints on movements of goods, especially food, and a system of agricultural procurement. The new planning model intensified these controls to conserve resources for development. We see then the rise of a “developmental government”.

The new “big push for development” claimed more and more resources for development activities—the many infrastructure boards, the mushrooming educational institutions, the many offices of development, and not to mention the various nation-building and defence establishments. The government grew rapidly both in size and influence; it became the largest employer in the country.

Fiscal resources began to be thinly spread and the governance sectors—justice, law and order, and security—were further squeezed. Thus began the new game of the government attempting to squeeze more resources from the population through many clever schemes of taxation, which the people resisted by moving into informal sectors that lay beyond the pale of the government. This continuous tussle between a government hungry for resources to spend on goods that society did not value and a people attempting an escape from “unjust” taxation eroded the social contract and faith in the government.

As the fiscal crunch deepened, cuts were employed across the board, often to the detriment of organisational efficiency. Maintenance and development expenditures were reduced; real wages were frozen; at times employment growth was also frozen. While organisations began to look depreciated with cuts in maintenance budgets, government servants began to claw for a living wage and more [Haque and Sahay (1996)]. They responded to the situation by expanding their perks, by legitimising rent-seeking and corruption and reducing accountability standards. The bulk of a government servant's earnings over time was derived from non-income sources such as perks and his/her pension depended purely on the acquisition of off-balance sheet, state-subsidised assets. This was done through making land development a major activity of the state, and marketing land through a subsidised sale to government functionaries.¹³ In the same vein, public sector corporations were means of maximising fiefdoms and perks. The result is a government machinery that lacks high-powered incentives,¹⁴ controls distorted land and goods markets, and enjoys reduced standards of work and accountability in the country.¹⁵

Recall that the new development thinking came packaged with resources from the IFIs and the official lenders and expatriate foreign advisers to fill the perceived skill gaps.¹⁶ Over time, all policy formulation functions were transferred to the donor.¹⁷ New governments or ministers who now seek fresh initiatives appeal to

¹³The army has learnt it well and uses this device effectively to keep its members happy.

¹⁴High-powered incentives are those that relate payment directly to job objectives.

¹⁵While the new tasks of economic development and market regulation required many new professional skills, the old civil service continued to operate on lifetime tenures to general administrators, who are then rotated in various positions.

¹⁶The expatriate adviser was given a large role from the very beginning because of the needs of the new development paradigm and because the country lacked economic skills [see Haque and Khan (1998)].

¹⁷The civil service, which did engage in some research and inquiry in colonial and early postcolonial times [see Braibanti (1966)], now appears to be quite limited in such activities.

donors for research. Government functionaries were therefore marginalised from policy analysis while being poorly paid and retaining the power of large government.

Basically, the “big push for economic development” led to an over-extended government manned by an unmotivated manpower that increasingly became unaccountable and engaged in rent-seeking and perk-maximisation. As these trends took hold, the quality of governance declined and market development and regulation increasingly became hostage to public sector rent-seeking. Merit, which even the colonials recognised, was now totally disregarded, leading to a flight of human capital from the government.

Markets, civil society, and openness played little or no role in this model. The government’s role expansion into economic development took place at the expense of the government’s ability to develop social contract goods such as justice, law and order, security of person, etc. The result was a secular decline in governance, to which the new so-called “developmental” government and its advisers remained blissfully unaware until the 1990s.

(b) Business and Enterprise Development

The theory of the times spoke of two gaps—domestic saving-investment gap and the shortfall of foreign exchange supply from what was required for domestic capital formation.¹⁸ For the first gap, the government borrowed (on behalf of the people) from official creditors and the IFIs. For the second gap, it was assumed that the country had limited foreign exchange earning capacity while the needs of the ‘big push for industrialisation’ required large amounts of imported inputs. Thus a policy was configured to earn foreign exchange by encouraging exports and by conserving it through curbs on imports and capital outflows.¹⁹

Given the two gaps—the savings and foreign exchange—it was natural for policy to prioritise the use of resources.²⁰ For achieving a “take-off” the government and its experts were expected to know the priorities, which were set to be an emphasis on industrial development for accelerated export growth and import

¹⁸Measured savings have always been low for Pakistan—much lower than in comparator countries such as India. For years this inadequacy of Pakistani savings has haunted our policy and our economists, and all manner of government savings schemes, dreamt up for increasing savings, have further exacerbated the fiscal deficit. Papanek (1967) argues for the need to generate inequality to enable the rich to generate savings. People reacted to an expanding government looking for resources, with large amounts of capital flight and informal savings especially in real estate.

¹⁹Thus developed the paranoia towards openness and a desire for control: even foreign travel and education abroad were privileges, to be severely restricted.

²⁰“When technological maturity is reached, and the nation has at its command a modernised and differentiated industrial machine, to what ends should it be put, and in what proportions: to increase social security, through the welfare state; to expand mass-consumption into the range of durable consumers’ goods and services; to increase the nation’s stature and power on the world scene; or to increase leisure?” [Rostow (1960)].

substitution. A variety of policies were used for this objective, but all of them amounted to a subsidy to industry. Infant industry arguments still continue to be used for protection to industry. Licensing, concessional financing schemes, and other subsidy regimes were also offered.

These restrictions did not develop entrepreneurship in the sense that modern economics and business has come to know. Schumpeter (1950), Knight (1921), and Drucker (1970) have defined an entrepreneur to be an innovator, a risk-taker, and a builder. Incentives of the type that were offered in Pakistan could not develop entrepreneurship of the Schumpeter-Knight-Drucker variety. The incentive regime has created more of a rent-seeking businessman used to gaming and (mis)using policy. It can be said that the business environment that this policy created was too protective of businessmen.²¹ Entrepreneurship was stifled as a result, while rent-seeking became the main form of business. This class of businessmen rather than entrepreneurs acquired wealth and learnt ways to manipulate the government to have policy set in their favour.²²

These policies contributed to slow growth in indigenous enterprise. As a result, wealth remained concentrated in the hands of those that the government favoured. Consequently, even in private enterprise, merit gave way to government discretion. Social mobility was sharply arrested!²³

An interesting ramification of this industry-focused mercantilist approach was the neglect of the service sector and internal commerce. Retail sector, which was probably the largest employer in the country, was really not regarded as contributing to growth and production. Many internal commercial activities were severely constrained because of the view favouring industrial production. City regulation came to offer space only to housing—that too for the very rich—small shops, government offices in city centres, and large industrial areas on the outskirts. Even schooling was an afterthought. There was no room for entertainment, hotels, shopping malls, even other commercial activities such as offices, warehouses, storage and wholesale activities. The result was that a growth of a host of activities such as construction, warehousing, hotelling, entertainment and retail was stunted.²⁴

(c) Summing Up the Early Themes

Thus, several themes were established in the early design of policy in Pakistan:

²¹Since there was no bankruptcy law, the government essentially took over industries that ran into difficult under the rubric of 'sick industries'.

²²Costs of business surveys have been pointing to the amount of time and resources that business is using to interface with government.

²³To his credit, Mahbub ul Haq, the only Pakistani economist to develop a public image, noted increasing inequality and rising monopolies and raised the slogan of '22 [controlling] families'.

²⁴For more on this important theme of neglected domestic commerce and stifled city development, see Haque (2004) and Haque and Waqar (2006).

- A domineering government relying on controls;
- A dependence on external capital which was to be rationed through some government policy—accompanying the funding was donor technical assistance, which offered policy advice sometimes in competition with domestic thinking;
- A production-focused economy seeking to industrialise;
- A mercantilist approach relying on export promotion, protection of import-substitution industry, and high-priced consumer imports;
- The establishment of a rent-seeking, non-entrepreneurial culture, which, with its resources, would seek to perpetuate itself.

It is these themes that Pakistani society and government would later have to contend with. Much of what happened later was the response of the society to these themes.

2. PATH-DEPENDENCE: HAS THE PARADIGM CHANGED?

The current paradigm has evolved like all other human activities. The economy is more open than it used to be: exchange controls have been eliminated as have import licensing and most non-tariff barriers. The average tariff is now virtually in keeping with the WTO norms. Banking and financial sectors have created a more globally integrated financial market. Privatisation has reduced the government's involvement in the goods and financial sector.

These reforms notwithstanding, the government's policy announcements and policies continue to be based on the earlier themes (see Box 2). In the most recent Medium-term Strategy articulated by the government, there seems to be a limited role for financial markets and domestic commercial activities. Points 1 and 2 emphasise production in the traditional manner and seem to also base it on a traditional stages of industry where heavy and technology-based industry is preferred. There is also a target for expanding the share of industry. It is not clear what instruments will be used. However, if past practice is an indicator, it will be a mix of subsidy and tariff protection. The only mention of services is in Point 5, and then it is only to generate employment. Point 7 once again notes the need for resources and savings with no mention of financial markets.²⁵

The schematics (Figure 1) that the MTDP produces to show its conceptualisation of the economy one again neglects the areas of markets, finance, and commerce. It is a production-oriented schematics in keeping with the original growth strategy.

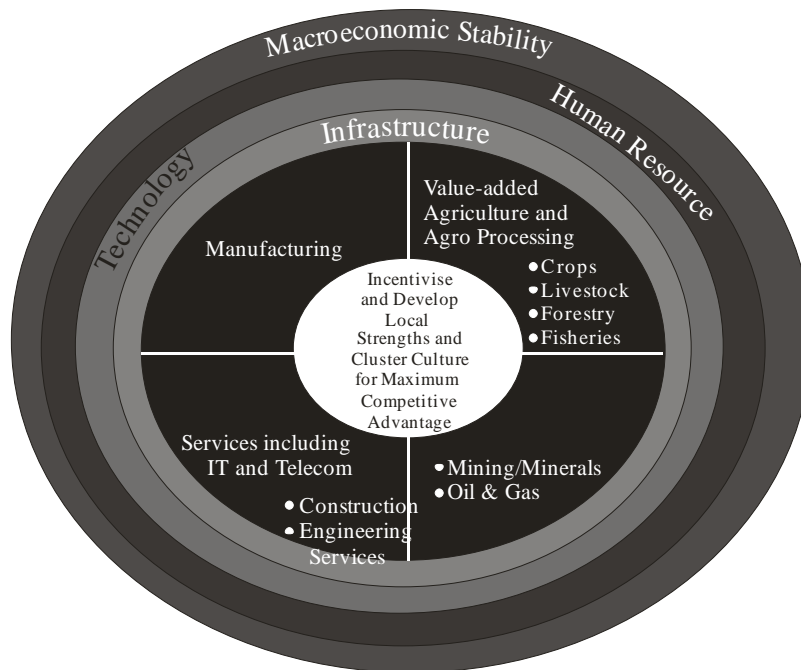
²⁵Recent growth literature has emphasised the role of finance in growth [see Demircuc-Kunt and Levine (2004), among others].

Box 2**The medium term framework—2005-10**

“The key elements of the MTDF strategy are as under:

1. In agriculture, not only crops but livestock and fisheries will also be developed, where a substantial improvements in yields, product quality and market efficiency are required to meet the growing demand for domestic consumption and exports.
2. In manufacturing, the production base would be expanded through the development of engineering goods, electronics, chemicals and other high technology-based and value added industries. Its share in GDP will be increased from 18.3 percent in 2004-05 to 21.9 percent in 2009-10.
3. The social and physical infrastructure would be expanded by investing more in water, energy, education and health and encouraging private sector to move into these sectors.
4. Adequate infrastructure and supply of trained and skilled manpower would be ensured to meet the requirements of a fast growing economy.
5. To generate employment and to reduce poverty, investment will be encouraged in agriculture and livestock, SMEs, housing and construction sectors.
6. In the export sector, efforts will be made to increase the role of technology and improve comparative export sophistication.
7. To encourage higher investment and savings, efforts would be made to provide the enabling environment to foster local and foreign investment and enhance both public and private savings.”

Medium Term Development Framework 2005–10, p. 5



(a) The Slow Pace of Reform

The perception in Pakistan is that these early themes continue and change only under pressure of the IFIs. From time to time, economic inefficiencies show up in terms of a build-up of macroeconomic imbalances such as an unserviceable debt build-up, rising inflation, and slowing growth. In such periods, the government tries intensifying controls and other administrative measures. When these fail and a sort of a crisis emerges, the IFIs are called upon to help. It is at such times that the agenda for reform moves up to the point where the crisis is averted and a comfort zone has been reached.

Thus motivated by crises, the IFIs' conditionality has been moving the agenda for reform. But this reform has been mainly concerned with improving the macroeconomic situation. Although the scope of the conditionality was expanded to deal with more fundamental problems when the crisis conditions proved to be stubborn, there has been little departure from the fundamental design established in earlier times. The following examples will clarify the point.

- Despite privatisation, the government remains dominant, as regulation and market intervention continue to grow.
- Protection remains intact for engineering goods; the basic mercantilist approach remains in place.
- Faith in openness and the market remains weak, though opposition is slowly being eroded.
- The framework of governance, including the bureaucracy, judiciary, and politics, remains virtually unreformed.
- Entrepreneurship/rent-seeking continues to be fostered through government policy.
- Pakistani media and intelligentsia still cling to an excessively large role of the government, a suspicion of the market, a bias towards industry backed by excessive protection.

Clearly, then, thinking remains path-dependant and the constituency for reform seems to be very small. Let us examine why.²⁶

3. EXPLAINING INERTIA

There is limited ideological challenge to these early themes. Five factors may be responsible for this inertia in development and growth strategy.

²⁶Surprisingly, despite the fall of the Soviet Union, the extended Japanese recession, as well as the East Asian crisis, the Pakistani economist and the debate in Pakistan continued to argue for a large government role, a planned economy, and mercantilism. They cling dearly to their suspicion of the market despite much evidence on efficient markets and the information aggregation and signalling role of markets that the economics profession has been developing internationally.

First, the stunted development of the economics profession meant that there was no research and debate to help evolve the framework of policy-making of the early years. As noted by Haque and Khan (1998), the economics profession was started by scholarships and government jobs according to the design of the donor experts. Primarily it was hosted in the Planning Commission and the Pakistan Institute of Development Economics as an adjunct to the government bureaucracy, which would deliver development. The role of economics in this model was considered to be mainly the assistance of the bureaucracy in Planning. Little investment was made in either theoretical economics or behavioural empiricism, which might overturn the assumptions of policy. This design has not delivered any independent research or discussion of policy.

Second, education investments have been inadequate in our early planning model.²⁷ All areas have suffered, but one area that particularly suffered has been higher education and research. Economics faculties did not develop in universities, syllabi did not evolve much, and no research challenged the early thinking discussed above.^{28,29} The research sector that could possibly challenge or inform the development paradigm did not develop.³⁰

Third, vested interests like the protected engineering goods lobby and the subsidised textiles lobby also continued to feed the earlier thinking of a domineering government and mercantilism.

Fourth, colonial bureaucracy has been maintained without reform and modernisation while their incentives have eroded. The colonial civil service system was designed to maintain administrative order of a colony. With new development

²⁷An unintended consequence of the production-oriented, mercantilist growth strategy was the neglect of human development; as a percentage of GDP, Pakistan has always allocated less for education than the average for developing countries [see Haq (1963) and Hussain (2003)].

²⁸Expert advice also maintained that higher education and research were considered luxury goods, activities to be pursued by more advanced countries. The World Bank argued in the 1970s and 1980s that the social rates of return to primary education were higher than those obtained in university education. There was a strong policy bias towards primary education away from higher education. [See Psacharopoulos and Woodhall (1985)].

²⁹Unlike India, where the IITs and the IIMs were set up as harsh meritocracies with a serious intent to compete with the advanced countries in research and learning, the bureaucracy in Pakistan effectively colonised Pakistani universities. Even today, no public sector university has any autonomy; government nominees and bureaucrats continue to serve on governing bodies, and the government determines appointments and transfers of university professors and management.

³⁰All academic and university appointments are regarded as part of the bureaucracy. All government servants—and the academia—are regarded as such. They are subject to the traditional human resource management and slotted into the uniform national pay-scales. A colonial legacy! Thus an academic can win international research awards but can only be promoted when the right seniority can be attained; and even then, according to the national pay-scales, a professor can never rise to the level of a federal secretary, the most senior rank in the bureaucracy. Needless to say, talent flew out of the academic sector, and it continues to do so.

and national functions—project management, market regulation, media operation and management, operating economic units—added on, more responsibilities and power has been handed to them. It is expected that this bureaucracy will perform both governance and development functions. While the governance function depends on the domestic fiscal situation and remains starved for funds, donor funding is amply available for the development. The bureaucracy has an incentive to be engaged in development projects at the expense of governance.

In addition public service human resource management has not changed since Independence. While the new demands on government required professionalisation, specialisation, and technical analysis, the civil service system continued to develop generalists who were fungible in all government business.³¹ A rapid and mandatory transfer system was maintained at the cost of specialisation, and as a disciplining device that served to politicise the civil service. The system is entirely based on seniority and political favours with no room for merit. Finally, the public service system is relatively closed; entry is only possible at a young age.^{32, 33}

Fiscal crises in the past have required restraining the wage bill. Money wages of civil servants have been declining in real terms for a long time. All the incentives of the civil servant lie in the perks that go with the job, and these have increased over time. Since the money wage is now a minor part of the public servant's wage, perks and rent management have become an important element of survival. Consequently, any reform that reduces perks and rents without adequate compensation in terms of cash will fail.

Fifth, the dominance of the government that was a part of the original growth strategy may now be impeding the evolution of the strategy. The design of development based on planning, licensing, and controls meant that the government determined market competition and success. As accountability and quality standards declined in government, economic and political success came to be measured in terms of whimsical benefits, such as land allotments, procurement contracts, monopolies, and arbitrary protection, of course derived from government regulation and dispensations. Competition for these has intensified over time, raising the cost of criticism and a demand for reform. Even well-intentioned political change finds the spoils of success quite tempting and often abandons reform.

³¹The technical work was handed out in the form of consulting contracts with no quality control. This has set up a new rent-seeking game, which contributes to further perverting incentives for both researchers and civil servants [see Haque and Khan (1998)].

³²Reform of the civil service, wider governance reform, as well as deeper structural reform required for economic efficiency have been discussed from time to time, especially at times of regime change.

³³Donors who initially had not thought these areas to be of importance have now put such reform on their list.

4. PARADIGM SHIFT: THE NEW DEVELOPMENT THINKING

In thinking of a new strategy, we must draw on fresh developments in economic thinking around the world. Some lessons from the large amount of research that has been done internationally are as follows.³⁴

- (1) Important determinants of economic growth are knowledge, creativity, and innovation. Societies that progress foster such activities.
- (2) For economic growth to take place, institutions must be configured to foster security of life, property, and contract, and to facilitate market development.
- (3) Economic activity grows in open competitive markets. Economic activity and innovation is chaotic and cannot be planned by government and, hence, must be left to markets.³⁵
- (4) Growth takes place in creative cities where individual liberty and economic freedom are maximised and community space developed to allow individuals to come together. Such cities are based on limited regulation since they encourage mixed use and commerce. Such cities foster knowledge clusters.
- (5) The role of government is not to plan and attempt mercantilist sector and industry picking, but to provide the institutions that will foster the four activities outlined above.

The new economics defines very clearly the distinct roles of the government and the marketplace. By managing its role well, the government defines incentives within society for creativity and innovation. Social mobility is determined by creativity and knowledge creation and not by government policy. Instead of rewarding rent-seekers, policy seeks to reward talent and innovation.

Clearly, 'the early design' that has been adhered to—a domineering role of the government, planning, and mercantilism—is inimical to the new economics. One major flaw in the path-dependant growth policies that we have been following has been the neglect of institutions and governance.

5. WHAT IS TO BE DONE?

(a) Accepting Markets and Globalisation

The key point to note is that an acceptance of globalisation means integration into the global economy and discarding the current approach of choosing areas in which to engage.³⁶ Globalisation is the linkage of markets across national

³⁴In many developing countries, considerable inertia in thinking is displayed despite attempts at liberalisation and advancing global communication. Inderjit Coomaraswamy, of the Commonwealth Secretariat says: "We seem to have liberalised our economies but not our minds".

³⁵For evidence of benefits of globalisation, see Bhagwati (2004) and Friedman (2000). Stiglitz (2003), whom many *dirigiste* thinkers quote, has some reservations on the international architecture but is quite accepting of most other aspects of globalisation.

³⁶This will mean a change in trade policy that seeks to protect favourites and to promote exports.

boundaries. Therefore, the benefits from globalisation can only be realised through market development. The domineering role of government has stifled market development [see Haque and Waqar (2006)].³⁷

If this approach is accepted, current emphasis on production would be replaced by market development. With this emphasis, a whole host of new approaches to economic policy will need to be developed. For example, every planned government intervention in the marketplace, including revenue initiatives, would need careful scrutiny at the technical level by a broad group of professional economists, think-tanks, and universities to understand their market implications before they are implemented. The yardstick for such an analysis and debate would have to be “all government intervention must be market-neutral and minimal”.

In market development, the issue of regulation would have to be faced. Two important points on regulation need to be recognised. *First*, that markets are self-organising and self-regulating. Regulation only affects areas of market failure where self-regulation does not work.³⁸ *Second*, each market is specialised and needs specialists with the requisite skills to regulate the market. Generalists being transferred from a government department most often will not do.³⁹

(b) Re-aligning Government to the Social Contract

Public policy research has clarified the role of the government to be one of correcting market failure and providing security to individuals and markets.⁴⁰ Government activity beyond the social contract needs to be carefully thought through. In this view, the role of the government is to provide governance first. Development can only be done by a government that can provide governance. Even government activities within the social contract need to be conducted with as much transparency and accountability as possible. Government efficiency and output must always be monitored.^{41, 42}

³⁷For example, agricultural procurement and storage currently remains dominated by government; subsidies to industry or exorbitant protection to some leads to a distortion in the marketplace.

³⁸That development is a chaotic and messy business best conducted through the market taking its own head is well-understood and has to be accepted. Policy must give this process space and be ready to help clean up where it can in an informed manner.

³⁹The dictum that ‘every market needs government regulation’ is convenient for rent-seeking and ignores all economic theory and empirical evidence. Often, regulation is built on bureaucratic lines and run by generalist bureaucrats.

⁴⁰All tasks of the government derive from this mandate of providing individual security and liberty and safeguarding the contracts and transactions conducted by sovereign individuals. Development projects and arranging for welfare and distribution are dimensions of improving welfare.

⁴¹One important function of parliament from its inception has been the monitoring of government.

⁴²An important part of the new governance movement started by Margaret Thatcher and the New Zealand reform has been the measurement of the quality of government and the continuous reporting of such governance. Of course, this assumes an open and transparent government where citizens have a right to know.

(c) Building Institutions and Governance

There is now widespread acceptance that institutions and governance need to be built for growth.⁴³ In reality, this has remained little more than wishful thinking since most often the effort of building institutions has relied on very expensive donor-funded projects driven by costly consultants with little impact on the efficiency or the quality of governance or institutions. The focus of most of this work is the importing of 'best practice', which incumbents with their current poor incentives are supposed to implement.

Institutions are the rules and norms accepted by the society as ones under which it will operate. [North (1990)]. This sets up a huge agenda—from the constitution to the norms and culture in society. Constitutions define the checks and balances which incorporate the basic incentives under which the society functions. Economists like Hayek (1978) contend that even this basic document needs to be aligned with economic efficiency, individual liberty, and maximum welfare of all.⁴⁴

Civilisation is based on two very important institutions—property rights and the rule of law—that need to be carefully developed and nurtured. The state guarantees property rights, the definition of which is continuously expanding with technology and population density. The former creates new goods and services as well as new uses for existing goods and services leading to possible rights conflicts or re-definitions and re-interpretations. Related contracting mechanisms also seek to define property rights and claims that again require informed and appropriate state intervention.

Similarly, with increasing population density, individual property rights have to be traded off with community welfare as crowded urban spaces increase social externalities. Space and environment need to be shared so that individual freedom and privacy are maximised while increasing community welfare. Public goods infrastructure, such as roads, sewers, and wiring will require the assertion of eminent domain. Unless an informed and thinking approach is used, 'eminent domain' can convey too much power to the executive and be used for rent-seeking.⁴⁵

⁴³See Acemoglu, *et al.* (2005) for a recent analysis of the impact of institutions on growth.

⁴⁴Constitutional economics is an important subject and should be taken into account at moments of constitutional deliberations. One reason that we run into a constitutional hiatus is that in both the framing of the constitution and its amendments, no expert of this field was consulted. [See Cooter (2000) and Hayek (1978)]. *The Federalist Papers* (2003) has a very good discussion of constitutional issues. Lord Acton's famous dictum 'power corrupts' remains true, and hence an important role of the constitution is to distribute power through checks and balances so that it does not concentrate anywhere.

⁴⁵There is another interesting area for research and reform here. Currently, land development takes place under the Cooperative Societies Act (c. 1912 and its amendments) and the Land Acquisition Act (c. 1894 and its amendments). The former has no legal entity or assets to give claimants any resource while the latter should not be used for development of housing for the rich.

An important ingredient for building governance is the establishment of the rule of law, which means an end of privilege and ‘network rent-seeking’.⁴⁶ Experience of development in many countries has shown that ensuring justice and the rule of law leads to good market development and enhances growth. Establishing the rule of law and a good system of justice has now become a matter of priority.⁴⁷ A resource-constrained government must therefore use its resources wisely, and ensure that the key institutions of governance that are required for security and market development must be properly developed.⁴⁸

**(d) Developing Creativity and Social Mobility:
From Rent-seeking to Merit**

Much recent research has emphasised that the key difference between the developing and the advanced countries is the creation and use of knowledge and creativity. In such an environment, merit must be incentivised at every level. This would happen if, as suggested earlier, the role of government is re-aligned, globalisation is accepted, and institutions built. What sort of institutions will allow this creativity to be unleashed?

- (i) *Shift to a consumer-oriented society.* Creativity can be built with a change in policy stance and regulation that sees all activity—and not just production—as equally valuable. This will require a change in emphasis from the current focus of policy-makers on supporting producers through essentially mercantilist policies to an economy that allows consumers more choices and greater weight in the economy. Policy will then have to allow more space, both metaphorically and physically, to services, and especially domestic commerce, currently stifled.⁴⁹

⁴⁶There is little sociological research in Pakistan even though much work is required. One area that has important ramifications for our economy as well as polity is what I would term as ‘network rent-seeking’. People are now working very hard to be a part of some important network to be able to engage in rent-seeking. Not only is this wasteful activity, it also destroys the socio-political fabric of the country and destroys the rule of law.

⁴⁷The principle of ‘equality before law’ is maintained by an independent, competent, and quality judiciary. The law must also show its responsiveness to change in society. Hence the legal system must also be capable of reform and innovation. The legal process must be fit for rapid enactment of needed laws and not be always dependant on a crisis or the external donor forcing a change.

⁴⁸In building institutions on the principles required by modern economic and legal thinking, competent research needs to be conducted and widely debated to enable a consensus for well-understood reform.

⁴⁹With better retail, warehousing, and leisure activities, the markets, output, and employment will expand. In an open economy, consumers will exert their preferences in the market through these activities. Economic activity will then take place according to the price signals conveyed by final consumer demand [Hayek (1945)]. Products will be developed to satisfy consumer demand. Chances of high-quality products and brand-names being developed will increase. And it is these products that will move overseas to increase domestic wealth.

- (ii) *Urban regulation for creative cities.* For this consumer-focused broader model, policy and regulation should accommodate the market development even though at times it may not be as orderly as the planners may like. Most important, regulation for city and land development and utilisation will have to be more accommodative of more city activities than are currently allowed. Currently, cities primarily allow for high-income single-family housing, small retail, and some industry. This approach also shuns urban density and values large open spaces with suburban housing. In the new model, much more density will need to be accommodated, including multiple family dwellings [see Haque (2004)].⁵⁰

5. SEQUENCING OF REFORM AND POLITICAL ECONOMY

With this deregulation and reorientation of the role of the government, a huge growth dividend may be expected.⁵¹ Yet there are opponents of this reform!

Is there a critical reform that will unleash other reform? Obviously, those favoured by current policy will not favour reform.⁵²

One important point of entry could be aligning the incentives of a key group with reform. One such group could be the public servants! Let us see why.

Given the prevalence of rent-seeking/perk-management in government, the incumbents probably self-select themselves on the basis of their ability to play this game. To such individuals, gains from reform may not outweigh those from rent-seeking/perk-management. The approach should then be to change the rules so as to allow people who are more invested in reform to come into positions where reform can be made.

To break the current hold, incentives have to be changed to allow individuals who would choose reform over rent-seeking to enter key public positions. This can only happen if—

- (a) the current closed civil service is opened up at all levels, i.e., all positions face external competition;
- (b) the generalist approach is discarded and appointments of professionals with the requisite skills are made;

⁵⁰In addition, city regulation should allow far more room for hotels, leisure activities, large retail, event management, office and other commercial space (see Appendix 1 for more details).

⁵¹Re-allocation of land resources within cities alone will open up many opportunities. New commercial activities, leisure, hotelling, and land development will absorb large amounts of investment, which multinationals will hungrily provide.

⁵²Complete opening of the economy and a wholesale deregulation that develops strong competition will be one important approach to moving in the direction of the new strategy. But the two most powerful groups—current favoured industrialists and government machinery—will strongly resist such a move and will convert *de jure* liberalisation into *de facto* closure.

- (c) reasonable security of tenure is given, i.e., transfer is discarded as a weapon of control;
- (d) mobility into and out of the public sector is encouraged;
- (e) perks are abolished and all payment is in cash and totally transparent; (performance-based bonuses are used; payments are competitive with the private sector;)
- (f) reform is rewarded with honours and payment at market levels.

With this approach, the government employees (judges, civil servants, public service delivery employees) can all hope to invest in reform and gain from it. Over time, the incumbents engaged in rent-seeking will be outnumbered. Such a public service will be able to take on the vested interests and align society's incentives with economic efficiency and growth.

From a political economy standpoint, it seems that the critical measure to trigger wider economic efficiency reform would be the reform of the public sector on the lines suggested here.^{53,54}

CONCLUSION

There is an urgent need to shift the growth paradigm in Pakistan. Much has been learnt about the growth process in the world, and this knowledge needs to be applied in Pakistan. The earlier approach based on government-centred planning, reliance on foreign resources, and mercantilism, has not worked because the structure of incentives that resulted from this approach led to a neglect of governance and the development of rent-seeking. Talent and merit were disregarded by that system.

Economists are now emphasising that for self-sustaining growth, such institutions need to be built that preserve individual freedom, provide security, and facilitate market transactions; the government merely provides these institutions, allowing markets to determine where economic activity goes. This is a meritocratic framework where success is determined purely by the marketplace, and where government efficiency is also judged by how well it develops the governance infrastructure that facilitates the market.

⁵³A complimentary reform would be catalysing thinking and debate on reform. This can best be done through a vibrant academia.

⁵⁴Unfortunately, the Pakistani media cannot be counted on the side of reform and progress. Contrary to Sen's famous argument that media is always an ally of reform and progress [Sen (2001)], the media in Pakistan has always been controlled by the government to more or less freeze out any debate, especially debates on alternative strategies or reform. Through the country's history, the government has found ways of controlling the media. Overt controls—licensing and direct censorship—were in place for many years. When these were given up, rationing of newsprint was used as a control device. When the media gained independence, the government had also grown to be the largest advertiser and hence retained control on the media. In Pakistan, the academia, through their interface with globalisation, will probably create the awareness and lead the media to publicise reform.

Given these new findings in economic research, Pakistan's growth strategy should be the subject of some debate. There may be a case for moving away from the current focus on government planning, production, and mercantilism to a more market- and commerce-based approach. The new approach would be more aligned with globalisation, creativity, and innovation.

Obviously, vested interests will block such reform. However, one possible intervention identified could help break the control of vested interests. The change has to take place at the level of acceptance of this new thinking, which can perhaps best happen through academic freedom and the development of a research culture. That will only come about when the education system, which currently is subservient to the government machinery, is completely autonomised and professionalised.

For reform to take hold, public service, which stands at the heart of the system, will need to be modernised in a manner that invests it in reform and takes it away from rent- and perk-management. My contention here has been that the crux of this reform of government will lie in the management of public service personnel—a management that allows open competition of a professional kind to be established.

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